

**COMMENTS ON SESSION IV:
FISCAL RULES IN A DECENTRALISED FRAMEWORK**

*Daniela Monacelli**

1. Introduction

The papers presented in this session raise some interesting issues, which many of us, especially those from EMU countries, will most certainly have to deepen in the near future. In my opinion, there are three main questions to be answered.

The first one has to do with EMU fiscal rules: is decentralisation necessarily a problem for EMU-specific rules and, if so, what should we really worry about? The second question concerns the need for measuring the deficit contribution of lower levels of Government: how are we to build good indicators and what do we mean by a “good” indicator? The third refers to the implementation of a sanction system vis-à-vis the decentralised bodies: is it necessary, useful, or feasible and, if so, what is the most efficient way to design it?

All the papers give interesting hints about these questions.

2. Decentralisation and EMU fiscal rules compliance

In their paper, Balassone and Franco analyse the problem of the possible inconsistency between the decentralisation processes, characterising most European countries, and the main goal of the Stability and Growth Pact (SGP), i.e. the need to re-assess sufficient margins for counter-cyclical policies at the national level.

In my opinion, the preliminary question to address concerns the implications of decentralisation for fiscal policy, in general. Therefore, in my discussion I would like to start by adding some points to what expressed in the papers about the general issue. I will then turn to the more

* Banca d'Italia. The opinions expressed are those of the author and do not commit the Banca d'Italia. This version has benefited of discussions with the authors of the session during the Conference.

specific aspects of policy co-ordination among different levels of government related to EMU fiscal rules and domestic stability pacts.

2.1 *Collective goods provision*

I would rather think of the “difficult union” mentioned in the title of the first paper in terms of the very traditional “Musgravian” sharing of functions between central and local levels of government, where the first is better suited for the stabilisation branch and the second for the allocative one. Unfortunately, such a normative approach does not give suggestions in case the different public sector’s goals turn out to contrast with each other. It is left to whatever collective choice mechanism to ensure the best solution. The “difficult union” is therefore nothing more than the problem of striking a balance in the trade-off between stabilisation and efficient allocation of resources.

Actually, the argument could be generalised, considering the “difficult union” as “the” problem always arising when the central government sets any target or fiscal rule applying to the entire public sector. The solution greatly depends on the accepted notion of decentralisation and, as I will try to argue, does not necessarily find an obstacle in higher degrees of decentralisation.

In analysing this issue, we need to go back to the never-ending question of the “preferred” or “optimal” degree of decentralisation. The problem is tackled from an efficiency perspective. In my opinion, the most useful approach is by the “fiscal equivalence” principle, as formulated by Mancur Olson: collective goods should be provided avoiding both externalities and internalities. In other words, the “boundaries” of the benefit area from the collective good should spread neither outside nor inside the “boundaries” of the government bodies providing it. In principle, “... *there is a need for a separate governmental institution for every collective good with a unique boundary, so that there can be a match between those who receive the benefits of a collective good and those who pay for it*.” Centralisation is just a special case, concerning those collective goods for which the boundaries of the benefit area coincide with the entire country. In general: “*It is... evident that both the ‘centralizing’ and*

¹ See Olson, M., “The principle of ‘fiscal equivalence’: the division of responsibilities among different levels of Government”, in *The American Economic Review Paper & Proceedings*, No. 2, Vol. 59, May 1969.

'decentralizing' ideologies are wrong, or at any event entail inefficiency. Only if there are several levels of government and a large number of governments can immense disparities between the boundaries of jurisdictions and the boundaries of collective goods be avoided. ... It is also evident that some of the complaints about the proliferation of governments and the overlapping boundaries of different types of governments need to be greeted with skepticism."

The most interesting insight of Olson's approach is in his understanding of the decentralisation as a dynamic process, stemming from interactions among economical, political and cultural forces acting in democratic societies. Consequently, to *gain efficiency* one country may need a more decentralised government than others², whenever the presence of much differentiated cultural patterns ask for a more articulated set of collective goods³.

Moreover, in setting the boundaries of the benefit from a collective good it is the *perceived* benefit rather than the *actual* benefit that matters. People may find the provision of particular collective goods desirable, although they do not directly benefit from them. Somehow, the equity aspects can fit into this "efficiency" framework. Consider, for example, the redistribution or the supply of those particular collective goods which a country may decide to guarantee to all citizens according to a uniformity principle (as in the German Constitution) or by a minimum standard (as in some Italian legislation). A comparative reading of the papers by Tannenwald, Gordo-Hernandez De Cos and Wendorff gives a very good example of the relevance of this issue, especially when describing the different arrangements chosen by their respective countries as far as education and health care are concerned.

To conclude, the main implication of Olson's approach is that "*... fiscal equivalence normally calls for larger, pluralistic jurisdictions as well as smaller ones matching cultural communities*"⁴. It is unquestionable that democracies have actually evolved according to such a principle since

² "Since different racial and ethnic groups often have different cultural backgrounds and tastes, they may want different types of collective goods. In cases where the sense of ethnic identity is very strong or where there is antagonism among different social groups, this is particularly important." Olson (1969).

³ See Olson (1969).

⁴ See Olson, M., "Towards a more general theory of governmental structure", in *The American Economic Review Paper & Proceedings*, No. 2, Vol. 76, May 1986.

the second half of the last century. In other words, the only possible generalisation is in that some degree of decentralisation is needed. Unfortunately, such a general model of decentralisation as the most efficient in absolute terms does not exist.

2.2 *The financing aspects*

Obviously, the convergence toward an efficient process is not an easy task to achieve. There could be cases where difficulties in applying the fiscal equivalence criterion are overwhelming. A crucial role under this respect is played by the institutional arrangements of the financial aspects.

There is a tendency among local public finance economists to consider tax autonomy more efficient than central government's transfers or public debt. In principle, any source of finance could be efficient. Public transfers, for example, prove to work much better than full tax autonomy when local supply is constrained (in quantity and/or quality) by the central level.

In asserting what is an efficient arrangement of public goods provision we preliminary need to focus on the choices underlying the collective goods provision. Among the others: the extension of the boundaries of benefits; the degree of responsibility in the supply at the decentralised level of government; technical difficulties arising in supplying the goods; any possible overlapping in the different goals satisfied by the collective good provision. Only relating to these characteristics of the public goods provision, is it possible to ascertain the matching between supply and financing capable of reaching efficiency.

In suggesting how intergovernmental financial relationships should be designed, economists need to bear in mind that efficiency usually results from two types of decisions. Sometimes, governments have to choose what goods and how much of each good has to be supplied, given a budget constraint. Sometimes, they need to implement the most "economical" use of the "flexible" resources available to them, given exogenous constraints on the level of the supply. Both situations happen to arise, depending on the characteristics of the specific collective goods. What is crucial, in this context, is that the two decisions are quite different in terms of the incentives or disincentives needed to improve efficiency. One consequence is that much differentiated financial arrangements prove necessary.

2.3 Does decentralisation necessarily endanger compliance with “central Government” fiscal rules?

Having clarified the underlying notion of “decentralisation”, we can go back to the original question, i.e. whether, *in general*, central government fiscal rules compliance finds an obstacle in decentralisation. If decentralisation is needed to promote efficiency in public good provision and if an efficient decentralisation can actually require several levels of government, as we argued so far, the *general* answer should be no.

Unless central fiscal rules are deeply in contrast with the target of allocative efficiency, it seems difficult to contend that *as a principle* decentralisation is going to endanger their compliance. It will depend on the fiscal rule. Actually, it could very well be the case that efficiency itself is the target pursued by the central government fiscal rule. Obviously, agency problems may arise, which could give incentives for decentralised governments to pursue different goals. However, they would have implications only as far as the dynamic process of decentralisation is particularly far from an efficient frontier and is hardly converging towards it. This could be the case, for example, when financial intergovernmental relationships are not sufficiently well designed.

Actually, it is very difficult to draw conclusions simply by analysing a pure static picture of the dynamic process of allocation over different levels of government. It is certainly true that from this kind of analyses there is a general tendency towards more decentralisation emerging in most developed countries. However, the observation of this phenomenon could simply pick up transitory situations where, for example, moves towards greater financial responsibility of local governments are just to complete previous moves toward greater responsibility in local collective good provision.

Whether this is bad or good for central government fiscal rules compliance, it is very hard to say. In Italy, the nineties’ were characterised by structural reforms of the local public finance that moved exactly on these lines. Economists had advocated them for a very long time. Many of us would find it hard to argue that such reforms have made it more complicated for the Italian central government to implement the fiscal consolidation needed to join the EMU. However, the decentralisation process is still going on and new issues are now arising, which will certainly deserve much of our attention.

2.4 *How decentralisation may endanger EMU-specific fiscal rules?*

As to the EMU-specific fiscal rules, therefore, it is questionable that decentralisation *per se* entails a compliance problem. However, some issues raised by decentralisation are still relevant. They mostly concern the implications from the EMU imposing to the European central governments a new common rule that is often *different* from the previous ones set at the domestic level. Many countries, indeed, had to switch from some form of explicit or implicit “golden rule” to a “balanced budget rule” applying over the cycle.

Changing the rule means changing one of the central government targets, and therefore means also changing the way public sector has to strike the balance among its different goals. Under these circumstances, it is very unlikely that the design of decentralisation is not affected, as in many cases allocational efficiency will require a re-shaping of the institutional arrangements. This process is slow and costly and could prove irreversible for some aspects.

Therefore, the relevant question has to do with the appropriateness of the rules set up at the super-national level in the first place. It is necessary to assess whether these rules are likely to be changed again in the near future or not, before embarking on deep amendments of the decentralisation system. The debate on the effects of the “balanced budget rule” on the public investment decisions, for example, moves exactly on these lines.

Finally, a second EMU-specific problem related to decentralisation arises because of the need to decide how to handle possible EU sanctions, but I will consider this point in par. 4.

3. Measuring the decentralised governments deficits

Despite the different views about the issue of fiscal rules in a decentralised framework, there is still a common problem to confront with, concerning the need for good indicators of decentralised governments’ policy action and, particularly, of their contribution to the deficit of the public sector.

Availability of such indicators is indispensable in order to ascertain the potential problem we might face; to give a dimension to it; to make it

feasible for the central government to apply rules vis-à-vis the decentralised bodies if necessary.

In building up such indicators, several aspects have to be considered.

3.1 *The fiscal rule*

The choice of the right variable to look at will obviously depend on the specific fiscal rule set by central government. As we heard from previous papers, rules could be set in a variety of ways, sometimes putting quantitative targets in terms of specific aggregates.

However, the rules set for the decentralised governments do not have necessarily to coincide with rules set at the central level, as long as consistency is preserved. Actually, central governments can more fruitfully translate their own rules into a different set of constraints, which they can specifically fine-tune on the local governments operating routines.

3.2 *The decentralisation scheme*

The fine-tuning argument brings us to the second relevant aspect when choosing a good indicator, that is the decentralisation arrangement each country has chosen. To begin with, the budget items that are “controllable” by the local bodies need to be singled out from the items that are “uncontrollable”. Only by doing so, we can get an accurate measurement of the impact of decentralised governments’ policy action. If not so, we would actually end up by measuring not only the policy contribution of decentralised bodies, but also the contribution of the central government through its interrelations with the decentralised governments.

The identification of the “controllable” items in the budget gives a first idea of how severe the problem of decentralisation could be in terms of fiscal rules compliance. Such an exercise facilitates detecting the dimension of the problem and identifying those items that, among the others, need to be more carefully checked upon. It could help the central government in calibrating a successful fiscal rule vis-à-vis the decentralised government. For example, in cases of relatively weak tax autonomy, a *rule set at the central level* in terms of *deficit* could be better attained by a *rule set at the local level* in terms of *expenditure caps*.

The Italian Domestic Stability Pact moves from a similar viewpoint. Indeed, it considers a particular definition of local governments' deficit, excluding all the intergovernmental transfers and, since 2001, the health expenditure (as it is still too much a rigid item in the regions budget to be included).

More generally, accurate analyses of accountancy aspects may prove very important. There is much to be gained from a better understanding of the relationships between the different stock definitions and the corresponding flow ones, or from deeper scrutiny of the methodology in sharing those aggregates among the different levels of government. Issue such as the choice between cash as opposed to accrual accounting can have relevant implications as well, as Robinson stressed in his paper with reference to the Australian experience. The more we know from numbers about the results of each decentralised body's policy, the more we are able to implement the preferred rules.

3.3 Other objectives of the central government

In choosing both the items and the methodology to build up the indicators, central government can decide to attach discretionary weights to each specific aspect of local government action. By doing so, central government realises its attitude towards local problems.

It is not rare for a country to show different degrees of willingness to adjust for different deficit originating conditions. Actually, several examples can be found of a "buffer" use of the central government deficit for local government deficit. Some act "vertically", the weights being differentiated according to functions. Others act "horizontally", the weights being differentiated by governments, within the same functions.

One case of the second type is that of countries characterised by deep initial inequalities in the regional distribution of resources. Under such conditions, central governments may want to recognise some extra-financing to the poorer regions, also by allowing higher deficit caps. Other cases, on the same wave, arise when extra-ordinary situations occur, like natural disasters, particularly bad economic shocks hitting only some areas, political crises, and so on.

Obviously, this is the most complex and maybe slippery of the aspects to consider in choosing an indicator of the decentralised

governments' policy action. It actually deepens into the trade-offs in public sector's targets, thus requiring explicit value judgements.

3.4 *Monitoring*

Another relevant aspect is the need for monitoring the chosen indicators. Some of them are better available during the year, while others can only be known with some time lag.

Usually, but not necessarily, the indicators we can check in a shorter time are less accurate than those we would actually like to target. However, the most urgent the need for monitoring, the more prone the central government is to accept an indicator which is far from the preferred target. In other words, sometimes there is no real choice for the central government administrators.

This issue becomes of vital importance when a sanction system is envisaged: the lack of good controllable proxies for the decentralised governments' action might be responsible for a total failure of the disincentives we would like to implement.

As a general conclusion, central governments should check for a wide range of indicators, each of which is chosen as the best appropriate in giving specific pieces of information. The strategy should be one of looking at all the indicators simultaneously, in order to draw together a satisfactory picture to rely upon when taking decisions.

4. A sanction system vis-à-vis the decentralised governments

As to the sanction system, there are two preliminary questions to ask: whether sanctions vis-à-vis decentralised bodies are necessary and, if it is so, whether they are feasible. By feasible we mean that we can actually design them so that they are successful in establishing the incentives or disincentives the central government wants to implement.

Several papers of this session discuss the implementation of a "Domestic" SGP: Balassone and Franco for Italy, Gordo-Hernandez De Cos for Spain and Wendorff for Germany. Current legislation in these countries does not seem to envisage very much structured sanction systems. It is difficult to understand whether the reason relies on the

legislator's belief that sanctions are not necessary or on some objective difficulty in calibrating them.

In tackling these issues, the central government has to take into consideration what role is expected to be played by the sanction system and what degree and kind of decentralisation characterises the public sector.

The *role of the sanction* can respond to very different requirements.

To one extreme, for example, we can envisage a system working *ex-post* as a mere *cost-sharing device* to simply redistribute the extra-cost of non-compliance with the central government fiscal rule. Costs could stem from a super-national sanction like in the EMU case or just from the undesirable economic effects from not meeting the policy target.

To the other extreme, we can think of a system working *ex-ante* as a *disincentive*. In this case, the central government pursues the compliance to a given public sector's target (a general government deficit, for example), independently of the existence of super-national sanctions like in the EMU.

In this case, the sanctions *vis-à-vis* the decentralised governments are just a mechanism to ensure reaching the desired policy targets in a decentralised framework. However, sanctions, in the sense of monetary sanctions as we seem to imply in our discussion here, are only one possible option. Other forms of "punishing" procedures could be enforced, like for example decreasing the power in the decision-making process. Such a solution could be adopted when there are institutional places constitutionally devoted to confrontation between decentralised governments and the central government.

More generally, central government must not necessarily rely on sanctions. Sometimes, better results could be achieved by implementing self-rewarding mechanisms into the policy action options of the single governments, i.e. by using incentives rather than disincentives.

The *decentralisation arrangements* affect both the feasibility and the role of the sanction system. They are critical in choosing the criteria for determining the distribution of sanctions among the single decentralised governments, as well. Here again, we have a wide range of possibilities.

From one side, we can envisage a pure "transfers criteria" scheme, where the sanctions are determined according to the same principles underlying the transfer distribution from central government. In other

words, sanctions would be treated just as negative transfers. This settlement could be desirable in situations characterised by low decentralisation in financing due, for example, to severe equalisation problems hampering a satisfactory fiscal autonomy to all of the local bodies.

This scheme is equivalent to having a central government that buffers entirely the “non-compliance” costs by reducing the overall amount of transfers to the lower levels of government. Alternatively, central government could choose to reduce other expenditures set at the central level.

At the opposite side, we can conceive a “non-compliance participation” scheme, where the sanction is distributed according to each government-specific contribution to the target failure (for example a “deficit participation” scheme where the sanction is tied to the excess deficit formation by each decentralised body). This criterion is appropriate in cases of high decentralisation in both expenditure and financing responsibilities, where “participation” in “non-compliance” is the result of authentically discretionary decisions by the decentralised governments. It obviously calls for very reliable indicators of the decentralised policy action.

